

in State X, but contends that State X is a foreign country and not a part of United States.

Situation 3. B, an individual, performed services in and resided on Johnston Island, one of the islands on Johnston Atoll. The Johnston Atoll is a Territory of the United States. B files a U.S. Federal Income Tax Return with a Form 2555 or a Form 2555-EZ in which he asserts that he is entitled to the exclusion from gross income under section 911 because he performed services in, is a *bona fide* resident of, and has a tax home in, a foreign country (*i.e.*, Johnston Atoll).

LAW AND ANALYSIS

Section 911 allows individuals that meet its requirements to elect to exclude from gross income certain foreign earned income. To qualify for the exclusion under section 911, a U.S. citizen or resident working abroad must have a tax home in a foreign country and satisfy either the *bona fide* residence test or the physical presence test. For purposes of section 911, States, Commonwealths, and Territories of the United States are not foreign countries. Treas. Reg. § 1.911-2(g) & (h).

In the situations described above, A and B do not meet the requirements for the exclusion from gross income under section 911. The claim that section 911 excludes income earned in a State, Commonwealth, or Territory of the United States because such State, Commonwealth or Territory is a foreign country has no basis in law or fact. Courts repeatedly have rejected similar arguments as frivolous, imposed penalties for making arguments such as these in court, and upheld criminal tax evasion convictions against individuals making such arguments. Courts repeatedly have rejected similar arguments as frivolous, imposed penalties for making arguments such as these in court, and upheld criminal tax evasion convictions against individuals making such arguments. *See, e.g., In re Becraft*, 885 F.2d 547, 549–50 (9th Cir. 1989) (rejecting the claim that federal law governs only the District of Columbia and U.S. territories and sanctioning attorney for making frivolous arguments); *United States v. Ward*, 833 F.2d 1538, 1539 (11th Cir. 1987) (affirming tax evasion conviction and noting that claim that federal law applies only the District of Columbia,

federal enclaves within States and U.S. territories is “utterly without merit”).

CIVIL AND CRIMINAL PENALTIES

In determining the correct amount of tax due, the Service will include income that taxpayers attempt to exclude based on frivolous section 911 arguments. In addition to liability for tax due plus statutory interest, individuals who claim tax benefits on their returns based on this and other frivolous arguments face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalty, which is equal to 20 percent of the amount of taxes the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a \$500 penalty under section 6702 for filing a frivolous return; and (4) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers relying on this scheme also may face criminal prosecution for: (1) attempting to evade or defeat tax under section 7201 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 5 years; or (2) making false statements on a return under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years.

Persons who promote this scheme and those who assist taxpayers in claiming tax benefits based on this scheme also may face penalties. Potential penalties include: (1) a \$250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer’s argument was frivolous (or \$1,000 for each return where the return preparer’s actions were willful, intentional or reckless); (2) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

HOLDING

Any position that the exclusion from gross income under section 911 applies to a taxpayer’s income because a State, Commonwealth, or Territory of the United States is considered to be a foreign country is frivolous. Taxpayers attempting to reduce their federal tax liability by taking frivolous positions based on this argument will be liable for the actual tax due plus statutory interest. In addition, the Service will determine civil penalties against taxpayers where appropriate, and those taxpayers also may face criminal prosecution. The Service also will determine appropriate civil penalties against persons who prepare frivolous returns or promote frivolous positions, and those persons also may face criminal prosecution. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622-4910 (not a toll-free call).

Section 6651.—Failure to File Tax Return or to Pay Tax

Tax avoidance schemes; meritless “corporation sole” arguments. This ruling emphasizes to taxpayers, tax scheme promoters and return preparers that, while a “corporation sole” is a legitimate corporate form that may be used by a religious leader to hold property and conduct business for the benefit of the religious entity, a taxpayer cannot avoid income tax by establishing a religious organization for tax avoidance purposes.

Rev. Rul. 2004-27

PURPOSE

The Service is aware that some taxpayers are attempting to reduce their federal tax liability by taking the position that the taxpayer’s income belongs to a “corporation sole” created by the taxpayer for

the purpose of avoiding taxes on the taxpayer's income. The Service also is aware that promoters, including return preparers, are advising or recommending that taxpayers take frivolous positions based on this argument. Some promoters may be marketing a package, kit, or other materials that claim to show taxpayers how they can avoid paying income taxes based on this and other meritless arguments.

This revenue ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with this scheme, that a taxpayer cannot avoid income tax by establishing a corporation sole for the purpose of avoiding taxes on the taxpayer's income. A corporation sole may be used only by a *bona fide* religious leader for specific, limited purposes relating to the religious leader's office. The argument that a taxpayer's income can be assigned to a corporation sole, and thus be exempted from taxation, has no merit and is frivolous.

The Service is committed to identifying taxpayers who attempt to avoid their tax obligations by taking frivolous positions, such as frivolous positions based on a meritless "corporation sole" argument. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through its Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether a court injunction should be sought to halt such activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

ISSUE

Whether a taxpayer may exclude income from taxation based on the argument that the taxpayer's income belongs to a

"corporation sole" created by the taxpayer for the purpose of avoiding taxes on the taxpayer's income.

FACTS

A "corporation sole" is a corporate form authorized under certain state laws to enable *bona fide* religious leaders to hold property and conduct business for the benefit of the religious entity. A number of individuals are promoting the use of these entities to avoid taxes on income and conceal the taxpayer's assets from tax collection. Participants in this scheme apply for incorporation under the pretext of being an official of a church or other religious organization or society. Participants then are provided with a state identification number that can be used to open financial accounts. Participants claim that their income is exempt from federal and state taxation because this income belongs to the corporation sole, which is claimed to be a tax exempt organization described in section 501(c)(3) of the Internal Revenue Code. Participants may further claim that because the taxpayer's assets are held by the corporation sole, the taxpayer is not subject to collection actions for the payment of personal federal or state income taxes or for the payment of other obligations, such as child support.

LAW AND ANALYSIS

A valid corporation sole enables a *bona fide* religious leader, such as a bishop or other authorized church or other religious official, to incorporate under state law, in his capacity as a religious official. See, e.g., *Berry v. Society of Saint Pius X*, 69 Cal. App. 4th 354 (1999) ("One purpose of the corporation sole is to insure [sic] the continuation of ownership of property dedicated to the benefit of a religious organization which may be held in the name of its titular head."). A corporation sole may own property and enter into contracts as a natural person, but only for the purposes of the religious entity and not for the individual office holder's personal benefit. Title to property that vests in the office holder as a corporation sole passes not to the office holder's heirs, but to the successors to the office by operation of law. A legitimate corporation sole is designed to ensure continuity of ownership of property dedicated

to the benefit of a legitimate religious organization.

A taxpayer cannot avoid income tax or other financial responsibilities by purporting to be a religious leader and forming a corporation sole for tax avoidance purposes. The claims that such a corporation sole is described in section 501(c)(3) and that assignment of income and transfer of assets to such an entity will exempt an individual from income tax are meritless. Courts repeatedly have rejected similar arguments as frivolous, imposed penalties for making such arguments, and upheld criminal tax evasion convictions against those making or promoting the use of such arguments. See, e.g., *United States v. Heineman*, 801 F.2d 86 (2d Cir. 1986) (upholding conviction for promoting use of purported church entities to avoid taxes); *United States v. Adu*, 770 F.2d 1511 (9th Cir. 1985) (upholding conviction for aiding and assisting in the preparation and presentation of false income tax returns with respect to false charitable contribution deductions to same type of purported church entities involved in *Heineman*); *Svedahl v. Commissioner*, 89 T.C. 245 (1987) (sanctioning taxpayer for using contributions to purported church entities similar to those involved in *Heineman* to shield income and pay personal expenses).

CIVIL AND CRIMINAL PENALTIES

In addition to having to pay the actual tax due plus statutory interest, individuals who claim tax benefits on their returns based on a "corporation sole" scheme or other frivolous arguments face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the section 6662 accuracy-related penalty, which is equal to 20 percent of the amount of taxes the taxpayer should have paid; (2) the section 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a \$500 penalty under section 6702 for filing a frivolous return; and (4) a penalty of up to \$25,000 under section 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers relying on this scheme also may face criminal prosecution for: (1) attempting to evade or defeat tax under section 7201 for which the penalty is a fine of up to \$100,000 and imprisonment for up to

5 years; or (2) making false statements on a return under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years.

Persons who promote this scheme and those who assist taxpayers in claiming tax benefits based on this scheme also may face penalties. Potential penalties include: (1) a \$250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous (or \$1,000 for each return where the return preparer's actions were willful, intentional or reckless); (2) a \$1,000 penalty under section 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under section 7206 for which the penalty is a fine of up to \$100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

HOLDING

A taxpayer cannot use a corporation sole as a means to exclude the taxpayer's income from taxation. Taxpayers attempting to reduce their federal tax liability by taking frivolous positions based on this argument will be liable for the actual tax due plus statutory interest. In addition, the Service will determine civil penalties against taxpayers where appropriate, and those taxpayers also may face criminal prosecution. The Service also will determine appropriate civil penalties against persons who prepare frivolous returns or promote frivolous positions, and those persons also may face criminal prosecution. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under section 7408.

DRAFTING INFORMATION

This revenue ruling was authored by the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact that office at (202) 622-7950 (not a toll-free call).

Section 6662.—Imposition of Accuracy-Related Penalty

Frivolous tax returns; meritless “claim of right” arguments. This ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with frivolous tax schemes, that there is no “claim of right” doctrine that permits an individual to take the position that either the individual or the individual's income is not subject to federal income tax. The ruling also describes many of the possible civil and criminal penalties that apply to people who make frivolous “claim of right” arguments to evade tax.

Rev. Rul. 2004-29

PURPOSE

The Service is aware that some taxpayers are attempting to reduce their federal tax liability by taking the position that either they or their incomes are not subject to tax based on what they describe or refer to as a “claim of right.” The Service also is aware that promoters, including return preparers, are advising or recommending that taxpayers take frivolous positions based on this argument. Some promoters may be marketing a package, kit, or other materials that claim to show taxpayers how they can avoid paying income taxes based on this and other meritless arguments.

This revenue ruling emphasizes to taxpayers, and to promoters and return preparers who assist taxpayers with this scheme, that there is no “claim of right” doctrine that permits an individual to take the position that either the individual or the individual's income is not subject to federal income tax. This argument has no merit and is frivolous. Section 1341 (“Computation of tax where taxpayer restores substantial amount held under claim of right”) of the Internal Revenue Code applies only when a taxpayer properly reports an amount of income in one taxable year and later repays all or a portion of that same amount in a later taxable year because the taxpayer, in fact, did not have an unrestricted right to that income.

The Service is committed to identifying taxpayers who attempt to avoid their tax obligations by taking frivolous positions, such as frivolous positions based on

a meritless “claim of right” argument. The Service will take vigorous enforcement action against these taxpayers and against promoters and return preparers who assist taxpayers in taking these frivolous positions. Frivolous returns and other similar documents submitted to the Service are processed through its Frivolous Return Program. As part of this program, the Service confirms whether taxpayers who take frivolous positions have filed all of their required tax returns, computes the correct amount of tax and interest due, and determines whether civil and criminal penalties should apply. The Service also determines whether civil or criminal penalties should apply to return preparers, promoters, and others who assist taxpayers in taking frivolous positions, and recommends whether a court injunction should be sought to halt such activities. Other information about frivolous tax positions is available on the Service website at www.irs.gov.

ISSUE

Whether section 1341, relating to amounts “held under claim of right,” allows an individual to reduce his or her federal income tax liability with respect to an item that was not included in gross income for a prior taxable year.

FACTS

Individual taxpayer A has gross income for taxable year 1. A claims deductions that equal or exceed A's gross income on A's individual income tax return for taxable year 1. A's claimed deductions may appear on various places on the return. For example, A may claim the deductions: (i) on Schedule A as compensation for personal labor; (ii) on Schedule C as a cost of A's labor; or (iii) on other schedules or elsewhere on A's return. Alternatively, A simply may not report all or some of A's gross income on A's return. Although the specific nature of A's “claim of right” argument for the position taken on the return may vary, A's position generally is that under a “claim of right,” either A or A's income, or both, are not subject to federal income taxes.

No portion of A's claimed deductions, or the amount of A's gross income not reported on the return, was included in A's gross income in any prior taxable year.